IN THE
SUPREME COURT OF MISSOURI

No. SC86932

MIDWEST ACCEPTANCE CORPORATION,

Appellant,

v.

DIRECTOR OF REVENUE,

Respondent.

RESPONDENT'S BRIEF

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ATTORNEYS FOR RESPONDENT
DIRECTOR OF REVENUE

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STATEMENT OF FACTS

This matter comes to the Court on a Petition for Review from the Administrative Hearing Commission.

Appellant Midwest Acceptance Corporation is a "credit institution," as defined by § 143.130(2).[1] For federal and state income tax purposes, Midwest elected "S corporation" status. *See* Appellant's Appendix ("App.") at A4. On July 28, 2004, Midwest filed a Missouri credit institution tax return for calendar year 2004. *Id*. On line 21C, Midwest claimed "Miscellaneous credits" in the amount of $77,800. *Id*. at A5. Midwest reached that figure by calculating income and taxes "as if" it had not elected Subchapter S treatment, *i.e.*, as if the corporation had "Missouri taxable income" despite that election:

Taxable income as a C corporation	$1,499,765
Federal taxes (as if a C corporation)	(254,960)
Missouri taxable income	1,244,805
Missouri tax credit (6.25% of Missouri taxable income)	77,800

Id.

On September 9, 2004, the Director issued a billing notice to Midwest, based on her determination that Midwest could not take the Missouri corporate income tax credit. *Id*. at A6. Though Midwest's calculations were based on Missouri income taxes of $77,800, Midwest neither showed nor claimed that it paid that tax. On November 16, 2004, the

[1] All citations to the Revised Statutes of Missouri are to the 2000 edition.

Director assessed $54,486, plus interest, in additional credit institution tax. App. A6.[2]

Midwest filed a timely complaint with the Administrative Hearing Commission, challenging the Director of Revenue's final decision assessing the additional credit institutions tax. *Id*. at A3. The Director and Midwest filed cross-motions for summary determination. *Id*. On June 7, 2005, the Commission largely upheld the assessment, finding that Midwest owed $49,899 in additional credit institutions tax. *Id*. at A15. Midwest timely petitioned for review in this Court.

[2] During 2003, Midwest Acceptance was owned in equal shares by James D. Newell, Jr., and Mary C. Dobkowski. Newell and Dobkowski filed 2003 Missouri income tax returns with their respective spouses. The Director did not make any adjustments to those returns. App. at A4.

ARGUMENT

INTRODUCTION

Neither the Director nor the Administrative Hearing Commission ("AHC") contest the point that dominates Midwest's discussion: that in the 1940's, the General Assembly drafted statutes – largely intact today – designed to impose on state banks and other financial institutions tax burdens comparable to those imposed on national banks.

But both federal and state law has changed since the 1940's. Most pertinent here was the creation of "Subchapter S corporations" – the tax treatment chosen by Midwest. Those corporations do not pay income taxes; their net income is attributed to the shareholders and taxed as part of the shareholders' income. They thus avoid what some call "double taxation": when a corporation pays corporate income tax and shareholders then pay income tax on dividends.

Under current Missouri law, a financial institution that elects Subchapter S treatment gets the burdens and benefits of that election. And here, one of the burdens is the loss of a tax credit that it would have if it were a C corporation.

Legislatures of the 1940's may have intended to ensure that all financial institutions are treated equally. But that changed in 1972, when the General Assembly followed the federal lead and authorized Subchapter S elections. And it changed again in 1998, when the General Assembly specifically addressed S corporation banks. The General Assembly did not make that modification available to other S corporation financial institutions, such as Midwest.

A. When a corporation elects Subchapter S treatment, it is not liable for corporate income tax.

In 1958, Congress modified the Internal Revenue Code by enacting Subchapter S, now 26 U.S.C. §§ 1361-1379. P.L. 85-866, § 64, 72 Stat. 1606, 1650-57 (1958). The purpose was to address, for corporations with few shareholders, the "double taxation" problem that is created by juxtaposing a corporate income tax with personal income taxes on dividends. This Court described the problem:

> One of the disadvantages of doing business in corporate form is the phenomenon of "double taxation." A corporation pays a tax on its net income. If any portion of net income is distributed to shareholders in the form of dividends, the taxpayers must pay individual income tax on the dividends.

Wolff v. Director of Revenue, 791 S.W.2d 390, 391 (Mo. banc 1990). *See also Hermann v. Director of Revenue*, 47 S.W.3d 362, 364 (Mo. banc 2001). ("The C corporation pays income tax on its taxable revenue, and the shareholders include corporate dividends in their own individual taxable income. This creates double taxation on a portion of the corporation's income.").

That "double taxation" problem does not exist for another common form of closely held business organizations: partnerships. Partnerships do not pay income taxes on the partnership level; their income is attributed to the partners and taxed as part of their personal income. *See* § 143.401. Thus the scheme existing prior to the enactment of

Subchapter S required closely held organizations to choose between the limited liability and other benefits of the corporate form, and the taxation advantages of the partnership form.

The new option created in Subchapter S gave qualifying corporations the opportunity to avoid the "double taxation" problem. As this Court has explained, "S corporations" are taxed like partnerships, avoiding income tax liability for the corporate level:

> Subchapter S . . . allows closely held corporations meeting certain criteria to pass their income through to the individual shareholders similar to a partnership. The shareholders in S corporations pay individual income tax on their pro rata share of corporate income, and the corporation as a separate entity pays no tax.

Hermann, 47 S.W.3d at 364. Fourteen years after Congress enacted Subchapter S, "Missouri, in line with its policy of following the federal tax model, enacted § 143.471." *Wolff*, 791 S.W.2d at 391. *See* 1972 Mo. Laws 698. Thus Missouri, like the United States, has "adopt[ed] the partnership statutes as the model for taxing the shareholders of S corporations." 791 S.W.2d at 391.

Shareholders of S corporations are taxed on the income of the corporation as if they, not the corporation, had realized the gain or incurred the expense. *Id*. Thus the "S corporation . . . is colloquially known as an 'incorporated partnership." *Id*. Its income simply falls outside the scope of Missouri's corporate income tax. In fact, the statutory language could hardly be clearer: "An S corporation . . . shall not be subject to the taxes

imposed by section 143.071," the corporate income tax. § 143.471.1. *See also Lloyd v. Director of Revenue*, 851 S.W.2d 519, 522 (Mo. banc 1993) ("After 1972, S corporations no longer had taxable income under chapter 143.").

B. Because S corporations are not liable for corporate income taxes, they are not given the benefit of corporate income tax deductions and credits except as specifically provided.

To ameliorate the impact of the corporate income tax, Missouri allows various deductions and credits. But again, with regard to the corporate income tax, S corporation are not taxpayers. So the deductions, exemptions, and other mechanisms that reduce that tax do not apply to S corporations.

For example, as explained in *Wolff*, S corporation shareholders cannot benefit from "Missouri's policy" of taxing only "income allowable to Missouri." 791 S.W. 2d at 392. "C corporations" – those that do not elect Subchapter S treatment – can "report[] only a portion of the corporation's net income" by "us[ing] an allocation factor to reduce the income figure on account of sales totally or partially outside the state." *Id*. But the "apportionment factor . . . is available only to corporate *taxpayers*, in corporate returns." *Id*. (emphasis added). Again, an S corporation cannot take advantage of this tax-reducing mechanism because, "[b]y the express language of 143.471.1, the S corporation *is not a taxpayer*." *Id.* (emphasis added).

Of course, the legislature hasn't completely resisted the urge to modify the purity of the Subchapter S election. In § 143.081.3 and .4, it allowed some specific corporate

exemptions to pass through to shareholders. Thus in *Herschend v. Director of Revenue*, 896 S.W. 2d 458, 460-61 (Mo. banc 1995), the Court allowed the shareholders/taxpayers to deduct taxes paid by the S corporation to Tennessee. [3]

But consistent with the general rule that "statutes creating exemptions from taxation are strictly construed against the taxpayer," *Fidelity Sec. Life Ins. Co. v. Director of Revenue*, 32 S.W. 3d 527, 529 (Mo. banc 2000), this Court has insisted that circumstances fit precisely within the scope of the exemption. Thus in *Hermann*, the Court refused to allow the individual taxpayers to take a credit for Arkansas corporate income taxes paid by the corporation because their corporation chose C, rather than S, status in Arkansas. As the Court pointed out, per § 143.081, a credit could be "passed through" only when "the payment [was] made 'by the S corporation.'" 47 S.W.3d at 365. And though the Hermanns' corporation had paid taxes to Arkansas, it had not paid them as an "S corporation." 47 S.W.3d at 363.

C. Midwest cannot obtain a credit for corporate income taxes it did not pay.

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[3]In *Herschend*, the Court observed: "Because of [the corporation's] 'subchapter S' tax status, corporate income tax liability is passed through to the shareholders." 896 S.W.2d at 458-59. Taken out of context, that statement could be misleading. True, liability for taxes on corporate income "is passed through to the shareholders" of an S corporation. But the liability is merely for personal income tax on their share of S corporation income; they are not liable for corporate income tax.

This case, of course, is much simpler than *Hermann* and *Herschend*. We need not worry about whether the taxes that Midwest paid were corporate income taxes as opposed to taxes of some other sort. Nor do we have to worry about whether Midwest paid taxes as an S corporation or as a C corporation. Midwest never claims that it paid Missouri corporate income taxes at all. Midwest has no corporate income tax liability.

The statute that Midwest invokes, § 148.041.1, provides for a credit based on "all taxes paid to the state of Missouri or any political subdivision." The logic and the language leads to just one result: that neither Midwest nor its shareholders can take a credit for corporate income taxes they never paid. As this Court observed in *Wolff*: "By the express language of § 143.471.1, the S corporation is not a taxpayer." 791 S.W. 2d at 392. Midwest cannot read § 148.041.1 "as though 143.471 did not exist." *Id*.

D. That the credit institutions tax permits a differential based on Subchapter S election does not justify a judicial rewrite of the statute.

Unable to point to any statute that permits it to take a credit for taxes it never paid, Midwest instead makes an innovative argument based on the history of Missouri constitutional and tax law. For purposes of this argument, the Director will not dispute Midwest's claim that the General Assembly, at about the time the 1945 Missouri constitution was drafted and ratified, wanted to structure a tax system that would affect national banks and other credit institutions as equally as possible. But that is entirely beside the point. The General Assembly, in enacting the credit institutions tax, simply did not consider the impact on S corporations – whether those corporations operate national banks or whether they operate some other form of financial institutions.

The reason for that omission is quite simple: As noted above, pp. 6-7, the financial institutions taxes were enacted in 1945, Subchapter S in 1958, and its state counterpart in 1972. To the extent financial institutions were organized as corporations before 1972, they were necessarily C corporations for purposes of Missouri taxation. The General Assembly did not, and logically could not, prophetically ensure that all financial institutions would bear equal tax burdens if some later chose Subchapter S treatment.

In a footnote on page 50, Midwest mentions that the General Assembly recently addressed one category of financial S corporations. In 1998, the General Assembly added a new provision to the bank franchise tax law. Section 148.031, RSMo 2000, allows banks that are organized as S corporations to do what Midwest wants to do: calculate the bank

franchise tax "as a nonelecting corporation," *i.e.*, as a C corporation. But the General Assembly did not make a parallel change to the credit institutions tax – not in 1998, nor since 1998.

The result is what Midwest disparages: a differential among credit institutions – *i.e.*, to the extent they elect Subchapter S treatment, institutions subject to the bank franchise tax are given a benefit not available to institutions paying the credit institutions tax. For S corporations, the bank franchise tax and the credit institutions tax are no longer as parallel as they once were. But Midwest identifies no constitutional bar to such a differential. And again, the differential is the unambiguous result of legislative acts.

Ultimately, this Court has already answered Midwest's assertions of unequal treatment: "The short answer to all these assertions is that the corporation has voluntarily elected to assume S corporation status. It could have elected to be taxed as other corporations are, but it made use of a choice expressly authorized by statute. It cannot have the benefits of the S election without the burdens." *Wolff* , 791 S.W.2d at 392-93, quoted with approval in *Lloyd v. Director of Revenue*, 851 S.W.2d at 522.

CONCLUSION

For the reasons stated above, the decision of the Administrative Hearing Commission should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that two copies of the foregoing were mailed, postage prepaid, via United States mail, on this 3rd day of November, 2005, to:

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CERTIFICATION OF COMPLIANCE

The undersigned hereby certifies that the foregoing brief complies with the limitations contained in Rule 84.06, and that the brief contains 2,433 words.

The undersigned further certifies that the disk simultaneously filed with the hard copies of the brief has been scanned for viruses and is virus-free.

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James R. Layton